Economic Outlook

Continued growth is expected throughout the forecast period, with unemployment rates remaining low. However, inflation is beginning to rise in the U.S. and California, and the Federal Reserve has raised the interest rate several times. The forecast does not incorporate impacts from the federal tax bill passed at the end of 2017. Individuals and businesses may change their behavior in response to new federal tax incentives, which may affect the economy in many ways. The impacts will be assessed in the May Revision.

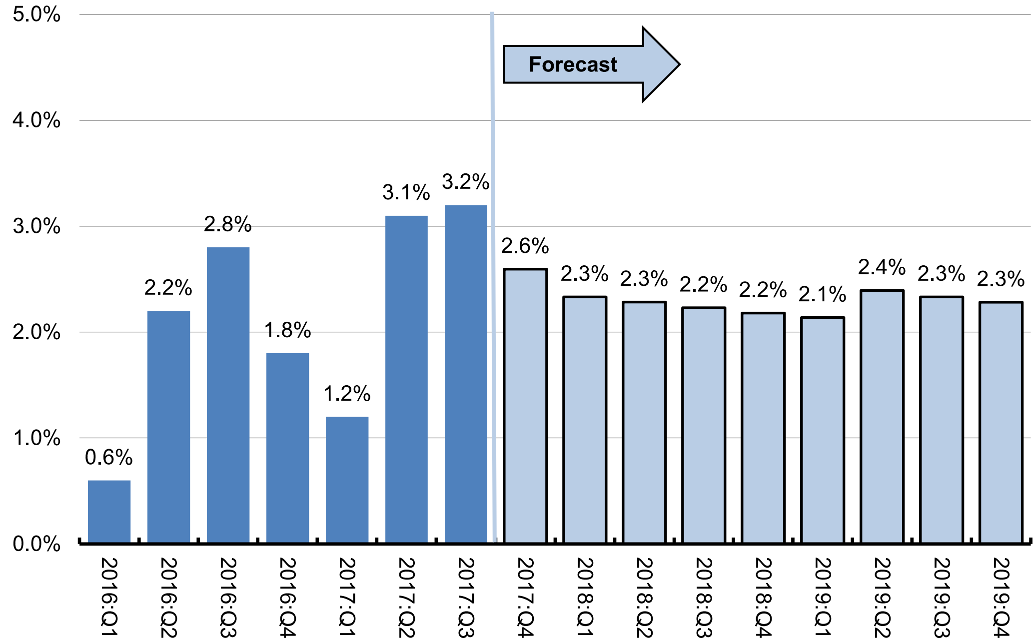
Besides the risks of a stock market correction, geopolitical events or an eventual recession remain the highest risks to California's economy.

The Nation—Continued Growth

The forecast assumes continued moderate economic growth over the next few years. In 2016, real GDP grew by 1.5 percent, as increases in consumption were offset by weak business investment. Business investment is expected to recover and consumption growth is expected to continue. (See Figure ECO-01 for details.)

The U.S. unemployment rate dipped to 4.1 percent in November 2017, the lowest since December 2000. Low unemployment is leading to higher wage growth. Meanwhile, jobs continued to be added at a slower pace, as both the U.S. and California have fewer people looking for work. U.S. inflation was 1.3 percent in 2016 and is expected to exceed 2 percent in 2017 as housing and energy costs rise. After the interest rate hike in December, the Federal Reserve is expected to continue to increase interest rates until the benchmark rate reaches 3.2 percent in 2021. See Figure ECO-02 for highlights of the national and California forecasts.

Figure ECO-01
U.S. Real Gross Domestic Product
Quarter-to-Quarter Growth, Annualized



Source: U.S. Bureau of Economic Analysis; CA Department of Finance, Governor's Budget Forecast.

California—Slowing Growth

California's unemployment rate fell to 4.7 percent in May and June of 2017, matching the all-time low unemployment in November 2000. The unemployment rate then rose to around 5 percent and is expected to remain near that level throughout the forecast (Figure ECO-03). Job growth is slowing, with an average of 21,000 non-farm payroll jobs added each month in the first three quarters of 2017 after 2016 monthly gains of around 30,000 jobs. From 2011 through 2016, the service sector accounted for 88 percent of the 2.2 million jobs added. From 2017 to 2021, that growth will slow, and construction jobs within the goods-producing sector will contribute almost 30 percent of the 1.2 million jobs added. Labor force growth was only 0.5 percent in 2017, but growth is expected to rise back to the population growth rate of 0.8 percent after 2018.

Average wages are rising faster than inflation, although at a slower rate than has been seen in previous episodes of low unemployment. This is due partially to retirements. As older, higher-paid workers are replaced by workers earlier in their careers, total wages and average wages will grow slower than the wages of each individual worker. Total personal income will also grow more slowly, since pension income is excluded from the economic personal income calculation. (The exception is Social Security income that appears in transfer payments.)

Figure ECO-02

Selected Economic Indicators

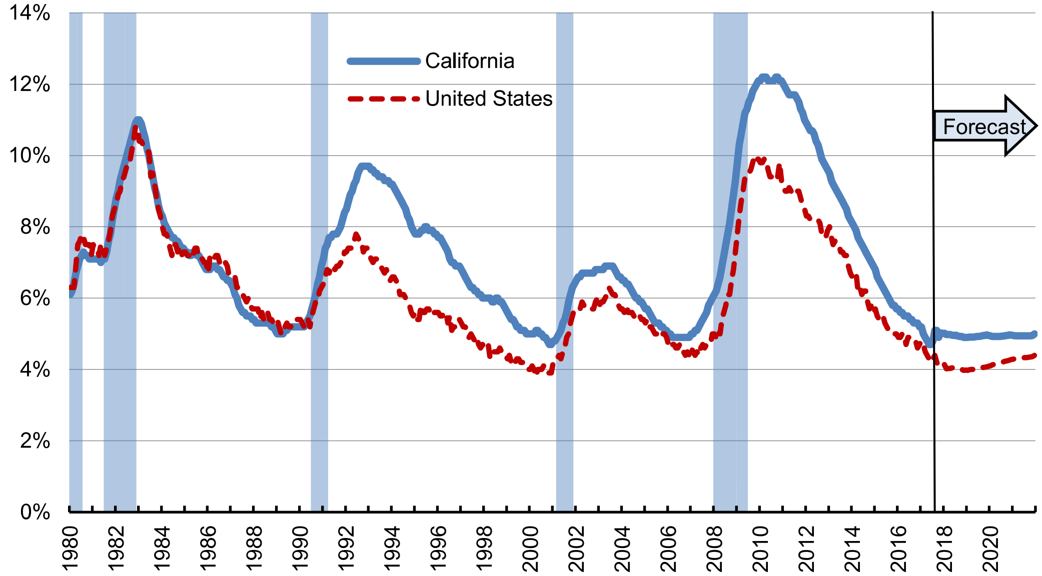
United States	2013	2014	2015	2016	2017 Estimated	2018 Projected	2019 Projected
Nominal gross domestic product, $ billions	$ 16,692	$ 17,428	$ 18,121	$ 18,624	$ 19,377	$ 20,256	$ 21,163
Real gross domestic product, percent change	1.7%	2.6%	2.9%	1.5%	2.2%	2.5%	2.2%
Contributions to real GDP growth							
Personal consumption expenditures	1.0%	2.0%	2.5%	1.9%	1.9%	1.7%	1.5%
Gross private domestic investment	1.0%	0.9%	0.9%	-0.3%	0.5%	0.7%	0.7%
Net exports	0.3%	-0.2%	-0.7%	-0.2%	-0.1%	0.0%	-0.1%
Government purchases of goods and services	-0.6%	-0.1%	0.3%	0.1%	0.0%	0.1%	0.1%
Personal income, $ billions	$ 14,074	$ 14,818	$ 15,553	$ 15,929	$ 16,428	$ 17,074	$ 17,899
Corporate profits, percent change	1.7%	5.3%	-1.1%	-2.1%	5.3%	11.4%	6.9%
Housing permits, thousands	991	1,052	1,183	1,207	--	--	--
Housing starts, thousands	928	1,001	1,107	1,177	1,190	1,253	1,372
Median sales price of existing homes	$ 197,400	$ 208,900	$ 223,900	$ 235,500	--	--	--
Federal funds rate, percent	0.1%	0.1%	0.1%	0.4%	1.0%	1.6%	2.3%
Consumer price index, percent change	1.5%	1.6%	0.1%	1.3%	2.2%	2.1%	2.2%
Unemployment rate, percent	7.4%	6.2%	5.3%	4.9%	4.4%	4.0%	4.0%
Civilian labor force, millions	155.4	155.9	157.1	159.2	160.4	162.1	164.0
Nonfarm employment, millions	136.4	138.9	141.8	144.3	146.4	148.3	149.8
California							
Personal income, $ billions	$ 1,862	$ 1,986	$ 2,134	$ 2,213	$ 2,304	$ 2,424	$ 2,520
California exports, percent change	4.0%	3.4%	-4.9%	-1.1%	--	--	--
Housing permits, thousands	86	86	98	101	110	122	139
Housing unit net change, thousands	59	69	68	89	--	--	--
Median sales price of existing homes	$ 407,150	$ 446,890	$ 476,320	$ 502,250	--	--	--
Consumer price index, percent change	1.5%	1.8%	1.5%	2.3%	3.0%	3.0%	2.9%
Unemployment rate, percent	8.8%	7.5%	6.2%	5.4%	4.9%	4.9%	4.9%
Civilian labor force, millions	18.6	18.7	18.9	19.1	19.2	19.3	19.5
Nonfarm employment, millions	15.2	15.6	16.1	16.5	16.8	17.0	17.3
Percent of total nonfarm employment							
Mining and logging	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.1%
Construction	4.2%	4.3%	4.6%	4.7%	5.0%	5.3%	5.6%
Manufacturing	8.3%	8.2%	8.1%	7.9%	7.8%	7.7%	7.7%
High technology	2.3%	2.2%	2.2%	2.1%	2.1%	2.0%	2.0%
Trade, transportation, and utilities	18.4%	18.3%	18.3%	18.2%	18.0%	17.8%	17.7%
Information	3.0%	3.0%	3.0%	3.2%	3.2%	3.2%	3.1%
Financial activities	5.2%	5.0%	5.0%	5.0%	4.9%	4.9%	4.9%
Professional and business services	15.4%	15.5%	15.5%	15.4%	15.2%	15.0%	14.9%
High technology	2.4%	2.5%	2.6%	2.6%	2.6%	2.5%	2.5%
Educational and health services	15.2%	15.2%	15.3%	15.4%	15.6%	15.7%	15.7%
Leisure and hospitality	11.1%	11.3%	11.4%	11.5%	11.6%	11.6%	11.6%
Other services	3.4%	3.4%	3.4%	3.4%	3.4%	3.4%	3.4%
Government	15.7%	15.5%	15.3%	15.3%	15.3%	15.3%	15.4%

Forecast based on data available as of November 2017.
Percent changes calculated from unrounded data.

Overall personal income growth should rise to above 5 percent in 2018 before subsiding to around 4 percent. As discussed in the Revenue Estimates Chapter, there will be increasing divergence between taxable personal income and the economic series for personal income.

Consumer inflation has averaged 1.9 percent in California and 1.6 percent in the nation since 2010, as measured by the Consumer Price Index. Inflation began to pick up in 2016 due to increasing housing costs, medical costs, and energy prices. Consumer inflation is expected to

Figure ECO-03
U.S. and California Unemployment Rate



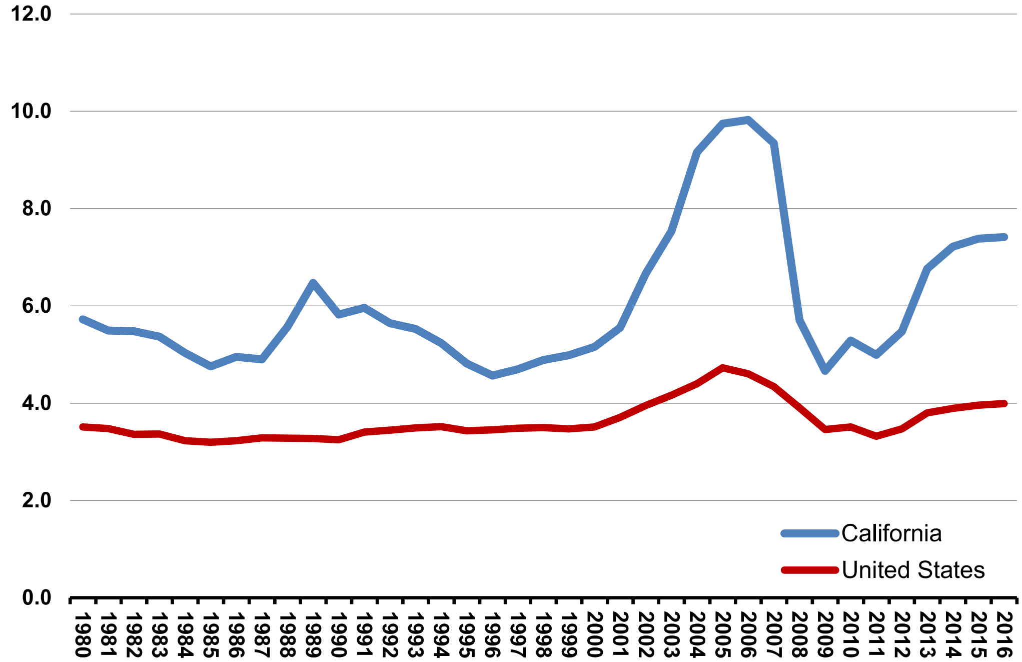
Shaded areas indicate U.S. recessions.
Source: U.S. Bureau of Labor Statistics; CA Employment Development Department, Labor Market Information Division; CA Department of Finance, Governor's Budget Forecast.

remain higher in California than the nation, with overall California inflation expected to average 3 percent in 2017 and 2018, and 2.9 afterwards.

Statewide housing permits averaged 109,000 in the first three quarters of 2017. However, housing permits issued by local authorities are expected to remain well below levels needed to account for population growth throughout the forecast period. This contributes to faster inflation in the state. The statewide median sales price of an existing single-family home was around $550,000 in the third quarter of 2017. While still below the high of almost $600,000 in the second quarter of 2007, California's prices are more than double the national median price of around $250,000.

As can be seen in Figure ECO-04, median home prices in California have been rising faster than median household income. As discussed in the Demographic Information Chapter, this is leading to more crowded conditions, especially in areas where jobs are being added. The housing constraints are assumed to lead to the slower job growth in the forecast.

Figure ECO-04
Median Home Price to Median Income Ratio



Median sales price of existing single-family homes / Median household income.
Source: CA Association of Realtors; U.S. Bureau of the Census; CA Department of Finance

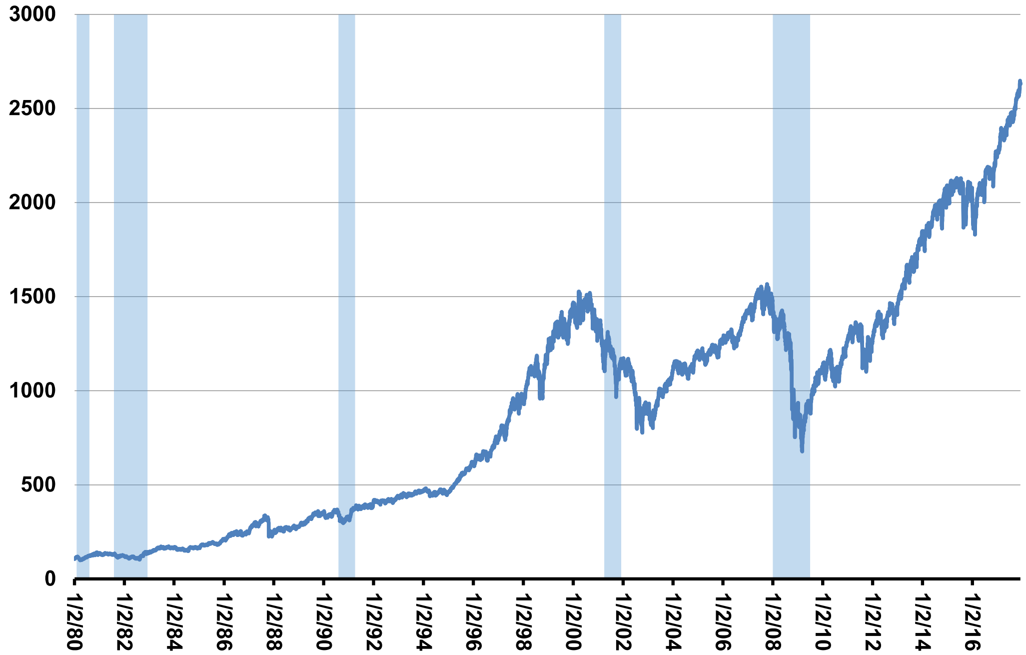
Risks and Challenges for a Changing Economy

The main risks to the California economic outlook are a stock market correction, an eventual recession in the U.S., or geopolitical risks that affect U.S. growth.

This forecast assumed no large changes to federal taxes, but the S&P 500 had begun to rise on the expectation of lower corporate taxes (see Figure ECO-05). This has continued since the passage of the tax bill in December 2017. However, continued stock price growth would need to be supported by underlying growth in the economy. Valuations of companies are relatively high compared with historical benchmarks. In the 2007-2009 economic downturn, the S&P 500 index decreased by more than half. An adjustment in the expectations of investors regarding future growth could be sudden. This would likely affect investment and hiring decisions at California companies, even in the absence of a recession.

The risk of a U.S. recession also remains. More than eight years after the end of the last recession, both the U.S. and California are at unemployment levels only seen near the end of an expansion. While the recovery was much slower than in previous expansions, there appears to be a limited amount of time that growth can be sustained. To keep growth on its current path, businesses would have to slow their hiring and wage increases in tandem with slowing consumer demand. Otherwise, inflation will rise further, and imbalances that trigger a recession would result.

Figure ECO-05
S&P 500 Index



Shaded areas indicate U.S. recession.
Source: S&P Dow Jones Indices

Geopolitical events such as wars in the Middle East, conflicts in Asia, or other incidents could also reduce U.S. growth or cause a recession. As with the rest of the U.S., the late 1980's trade policies in favor of a more integrated world market enabled many California companies to take advantage of the more favorable world market access conditions by either selling their products to new foreign market destinations, or by engaging in world supply chains which enabled them to increase productivity and decrease production costs. As a result, California and U.S. ratio of exports and imports of goods to GDP increased to 22 percent and 20 percent in 2016, respectively. Disruptions to trade would hit California particularly hard.